Internal Revenue Service

memorandum

CC:TL:TS
JHELKE

date: JUL 17 1987

to: Special Trial Attorney, International North Atlantic

from: Director, Tax Litigation Division CC:TL

subject: Request for Technical Advice - [redacted]

Issue

Whether the petitioner, who is treated as a dealer under I.R.C. § 1236 with respect to his trades on the Chicago Board Options Exchange (CBOE) in stock option straddle transactions in which he is a market-maker, should also be treated as a dealer in stock option straddle transactions in which he is not a market-maker?

Conclusion

The petitioner, who is treated as a dealer under section 1236 with respect to his trades on the CBOE in stock option straddle transactions in which he is a market-maker, should not be treated as a dealer in stock option straddle transactions in which he is not a market-maker.

Facts

The petitioner is a professional trader on the CBOE. In [redacted], he had both primary stock assignments and supplemental assignments. The petitioner executed approximately [redacted] contracts in [redacted] of which approximately [redacted] contracts involved [redacted], a stock in which he was not a market-maker. As a result of his stock option straddle transactions in [redacted], the petitioner claimed approximately $[redacted] in ordinary losses in [redacted] and a large ordinary gain in [redacted].

The petitioner claims that his status as a market-maker with respect to his market-maker activities makes him a dealer under section 1236 and therefore his dealings in the stock in which he was not a market-maker should be recognized as ordinary income or loss.

As we understand it, market-makers and options specialists are registered with the SEC as broker-dealers, and trade on the floor of options exchanges either for their own account or as agents for others. Market-makers compete with each other to make markets in various options traded on the exchange. Kramer, Taxation of Securities, Commodities, and Options § 6.3(c), (1986).

Law and Analysis

I.R.C. § 1234(a) describes the tax treatment for holders of options. Section 1234(b) sets forth rules for the tax treatment of grantors (writers) of options. Section 1234(b)(3) provides that section 1234(b) does not apply to "any option granted in the ordinary course of the taxpayer's trade or business of granting options." The effect of this rule is to cause so-called dealers or market-makers to recognize ordinary gain or loss on the treatment of writing these type of options.

Additionally, the legislative history of section 1234(b)(3) indicates that taxpayers who make a market with respect to certain options receive ordinary gain or loss treatment on their transactions. The Ways and Means Committee Report contains the following statement:

> "Treatment of Broker-Dealers": gain or loss from transactions and options written in the ordinary course of the taxpayer's trade or business would continue to be treated as ordinary income or loss . . . The determination as to whether an option was written in the ordinary course of a taxpayer's trade or business, or as an investment, is to be determined under principles similar to those which apply under present law in the case of broker-dealers in stock or securities. Generally, it is anticipated that persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to a particular option. H.R. Rep. No. 1192, 94th Cong., 2d Sess. 10 (1976), 1976-3 C.B. (vol. 3) 19, 28.

This report could lead one at that time to conclude that options market-makers were dealers. It does not however completely answer the question as to whether an options market-maker who trades in options for which he has no market-making responsibility should also receive ordinary income treatment. However, assuming for purposes of discussion that market-making in options would be considered a taxpayer's trade or business, the question is then whether an options dealer, without statutory blessing, should be treated as dealer for tax purposes with respect to his non-market-

making activities. In Reinach v. Commissioner, 24 T.C.M. (CCH) 1605 (1965), aff'd, 373 F.2d 900 (2d Cir.), cert. denied, 389 U.S. 841 (1967), a professional writer of options deducted option losses as ordinary losses incurred in his trade or business as a dealer in options. The taxpayer's principal source of income was the writing of options and he maintained an office with a salaried staff with rented private telephone lines to brokers and wrote option contracts over a three year period. The Tax Court held that since the taxpayer held no securities for sale to customers, he was not a dealer in securities and, therefore, his losses were capital in nature. Therefore, while the literal language of section 1234(b)(3) appears to apply to taxpayers who are in the trade or business of writing options, the Tax Court did not recognize the writing of options, alone, as a trade or business.

In a technical advice, 8141035 (June 30, 1981), an options market-maker was treated as a dealer in options and securities and was required to use an inventory to determine his income. As a consequence, the taxpayer paid tax at ordinary income rates. The technical advice discussed the fact that a call option gives the option holder the right to purchase stock at a specified price and time and, therefore, a call option is a "right to subscribe or purchase" stock and falls within the definition of "security" under section 1236(c). Since a market-maker is a dealer with respect to call options that he buys and sells and with respect to the underlying securities that he purchases to satisfy his obligations under short call options, such securities were considered to be a necessary part of his trade.

In addition, the Joint Committee on Taxation addressed the extension of section 1256 treatment to certain dealer equity options held by option dealers. The Joint Committee implied that option market-makers were treated as realizing ordinary income or loss with respect to their option transactions. See Staff of The Joint Committee on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 302 (Committee print 1984).

Under pre-1984 law, one could conclude that taxpayers who made a market with respect to particular options should be treated as being in a trade or business with reference to those options transactions. Since the transactions in question, which generated ordinary losses and gains affecting a deferral from [redacted] to [redacted], involved option straddles in stock in which the petitioner was not a market-maker, it is our conclusion that he should not be treated as being in a trade or business for purposes of these transactions. Accordingly, he should be treated as an investor and therefore subject to capital loss or gain treatment, as the case may be, on the option straddle transactions in stocks in which he was not a market-maker.

If you need to discuss this further, call Joel Helke at FTS 566-4174.

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